July 8, 2019

The Honorable Randal Quarles
Chairman, Financial Stability Board
Vice Chairman for Supervision
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

RE: Next steps on Addressing Market Fragmentation

Dear Vice Chairman Quarles,

We are writing to you today in strong support of the critical work you and your colleagues have undertaken – through the Financial Stability Board (FSB), the International Organization of Securities Commissions (IOSCO) and under the leadership of the Japanese Presidency of the Group of 20 (G20) – to address the increasing levels of fragmentation in financial markets.

As you know, market fragmentation can undermine the progress that has been made in rebuilding resilience of the global financial system since the financial crisis and can have negative consequences for economic growth and job creation. Fragmentation resulting from excessive regulatory and supervisory divergence can endanger financial stability by trapping capital, liquidity and risk in local markets, create significant financial and operational inefficiencies that generate unnecessary costs to end-users, and reduce the capacity of financial firms to serve both domestic and international customers.

As such, the IIF is encouraged that the G20, FSB and IOSCO have identified market fragmentation as a top priority. Given the critical importance to the financial system and the challenges that remain, we urge the G20 and global standard setters to continue to prioritize work on market fragmentation going forward and into future G20 presidencies. In this context, we are supportive of the separate but complementary reports published by the FSB and IOSCO on June 4 to analyze the issue of regulatory-driven market fragmentation.[1] As you are aware, the issues addressed in these reports are consistent with those which the IIF has analyzed in detail as described in our own report from January: "Addressing Market Fragmentation: the need for enhanced global regulatory cooperation."[2]

With these important reports, the FSB and IOSCO have acknowledged that market fragmentation is a serious issue and called on the global regulatory community for a coordinated response. We were very encouraged by the subsequent commitment of the G20 Finance Ministers and Central Bank Governors to address unintended, negative effects of market fragmentation, including through regulatory and supervisory cooperation.[3] We agree that it is crucial that the FSB, individual standard setters and member jurisdictions cooperate closely on solutions – it is the only way to develop harmonized and consistent approaches that will be fully accepted and faithfully implemented globally. The G20 and FSB should encourage jurisdictions to address fragmentation where it already exists.

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[1] See the "FSB report on market fragmentation" and IOSCO's "Market Fragmentation and Cross-border Regulation", both published on June 4, 2019.
[2] IIF 2019.
[3] G20 Finance Ministers and Central Bank Governors 2019. *Communiqué* (June 8-9).

The reports' focus on solutions is very constructive, and we support the ways discussed in the report in which market fragmentation might be reduced with a resulting positive impact on financial stability, or on market efficiency without any detrimental effect on financial stability. As mentioned in the reports, there are already notable success stories where steps have been taken to reduce market fragmentation. We are encouraged, for example, by the IOSCO Multilateral Memorandum of Understanding promoting the need for mutual cooperation and consultation among IOSCO members to ensure compliance with, and enforcement of, their securities and derivatives laws and regulations. The regulatory community can learn from and build on helpful precedents.

Addressing and avoiding market fragmentation will be an ongoing effort that depends upon coordination and cooperation across jurisdictions. We agree with your own assessment that "the work of the FSB reflects the fact that, in a global financial system, we cannot see and address emerging problems alone. Working as allies and colleagues, we have bound up most of the wounds from the last financial crisis. To avoid reopening them—and returning to a fragmented international regime—we will have to recommit to collaboration, embrace insight where it emerges, and follow evidence where it leads."[4]

We also agree with the advice in the FSB report that the possible fragmentary effects of regulation need to be considered "more prominently and systematically during the standard-setting process."[5] This means that adequate consideration and analysis of potential market fragmentary effects is needed right from the policy development and consultation phases through to implementation, monitoring and ex-post evaluation and review.

As we suggested in a letter to Mr. Ryozo Himino, Vice Minister for International Affairs at the Japanese Financial Services Agency (JFSA), in April,[6] the FSB could develop a monitoring framework that seeks to identify and measure the extent of market fragmentation across the financial system. Measurement by the FSB could help support a proper diagnostic and an identification of the root causes behind fragmentation. The FSB should regularly report on this monitoring, with potential oversight by the G20 to provide guidance and political priorities.

We strongly support the specific next steps set out in the FSB's report, regarding:

- Encouraging deference processes in derivatives and securities markets;
- Addressing jurisdictional ring-fencing and pre-positioning of financial resources by international banks;
- Enhancing regulatory and supervisory communication and information sharing; and,
- Incorporating market fragmentation as part of the evaluation of reforms.

We also value the broader discussion among authorities of some of the mechanisms and approaches discussed elsewhere in the report to enhance the effectiveness and efficiency of cooperation. For example, we value the FSB's suggestion to encourage a more consistent approach to data reporting and sharing.

In the short annex accompanying this letter we expand on the FSB's specific next steps and suggest additional ideas that could be considered by the G20, FSB, IOSCO, other global standard setters and member jurisdictions to address market fragmentation.

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[4] U.S. Federal Reserve 2019. Randal K. Quarles. "The Financial Stability Board - beyond the fog of battle" (April 2).
[5] FSB 2019. "FSB Report on Market Fragmentation" (June 4). Page 15.
[6] IIF 2019. Letter to the Japanese Presidency of the G20 "RE: Addressing Market Fragmentation" (April 5).

Given the ambitious scope of this initiative, and the FSB commitment to review progress on the above-mentioned specific next steps in November 2019, we would encourage both the subsequent G20 Presidencies and the FSB to continue to prioritize the topic of market fragmentation.

This is clearly an issue on which the public sector should continue to seek industry and stakeholder input to solutions. Financial institutions are directly impacted by market fragmentation and are very well placed to identify where progress is being made or barriers remain. The IIF and our members would appreciate the opportunity to remain closely engaged with the FSB and standard setting bodies on this topic, including at future workshops and roundtables.

Thank you for taking our views into consideration around this important initiative. We look forward to continuing to contribute constructively to your work in this area. If you have any questions in the meantime, please do not hesitate to contact Andrés Portilla (aportilla@iif.com).

Sincerely,

Axel A. Weber
Chairman, UBS Group AG
Chairman, Institute of International Finance

Timothy D. Adams
President and CEO
Institute of International Finance

cc: Mr. Ashley Alder, Chair, International Organization of Securities Commissions (IOSCO)
Mr. Ryozo Himino, Vice Minister for International Affairs, Financial Services Agency, Government of Japan

Annex: Additional suggestions related to the next steps in the FSB Market Fragmentation report[7]

Action 1. Deference processes in derivatives and securities markets

The IIF welcomes the FSB's call for IOSCO and CPMI to consider whether there are ways to strengthen and widen the use of deference processes in derivatives or securities markets. We positively encourage IOSCO and CPMI to formally endorse this call and organize specific work around strengthening the use of deference. This would build on some good precedents that already exist in that space. But we think that deference could be used more often and more broadly by home and host supervisors. The FSB should target fragmentation by defining a consensus approach and overall framework for cross-border regulatory cooperation and coordination in banking, markets and insurance regulations. To this end, greater use of equivalence recognition, passporting and similar tools needs to be considered further, without affecting regulatory sovereignty.

The FSB should encourage fair and proportionate regulatory and supervisory treatment of foreign subsidiaries of financial groups, to enable them to compete on a level playing field with local competitors. This enhances competition, diversification of financing sources, reduces costs to end-users and enhances financial stability. Such a level playing field should be achieved preferably through recognition of equivalence of the home regulatory and supervisory regime, whenever deemed prudently justified, rather than imposing burdensome overlapping host regulations. Streamlining should also include licensing requirements, where a host supervisor should avoid unnecessarily burdensome processes whenever a home regulation framework is adequate.

Jurisdictions should make more use of mutual recognition and equivalence between home and host supervisors to recognize the oversight in jurisdictions where regulation has a comparable outcome. In making equivalency decisions, the FSB should encourage jurisdictions to consider existing FSB, BCBS or other compliance assessments to achieve a greater level of accountability and stability of outcomes.

Action 2. Jurisdictional ring-fencing and pre-positioning of financial resources by international banks

This is a pertinent issue given the trend in recent years toward ring-fencing by host jurisdictions, as evidenced by the Intermediate Holding Company/Combined U.S. Operations requirements in the U.S., and the recently agreed Intermediate Parent Undertaking requirement in the E.U. These initiatives significantly limit the ability of firms to do business in foreign jurisdictions and thereby affect the quantity and quality of finance offered in different jurisdictions. But it is not only an efficiency issue. As observed in the FSB's report and the IMF's 2018 Global Financial Stability Report, [8] an excessive siloing of capital and funding resources within national borders can be to the detriment of the overall resilience of financial institutions. For instance, such requirements that are not commensurate with the actual risk in those entities can constrain the degree to which financial institutions use capital and liquidity to meet shocks to their solvency and funding that occur across different jurisdictions.

[7] FSB 2019. "FSB report on market fragmentation" (June 4). Pages 18-19.
[8] IMF 2018, "Global Financial Stability Report: A Decade After the Global Financial Crisis" (October).

In the future analysis on this issue, which the FSB has committed to undertaking in the second half of 2019, it will be important to pay due regard to the impact of geographic ring-fencing on financial stability and the real economy. The supervisory and resolution authorities could discuss ways of overcoming conflicting supervisory expectations through dialogue or other protocols. Supervisors should remain “neutral” vis-à-vis business operating models. Colleges and crisis management groups, while valuable as forums for information sharing, could also be used more widely to address cross border supervisory inefficiencies.

As each relevant home and host jurisdiction translates the provisions of the TLAC Term Sheet into local regulation, it is worth noting fragmentation around the calibration of internal TLAC. While some jurisdictions are calibrating or proposing calibrating internal TLAC at the low end of the TLAC Term Sheet range (from 75% to 90%) at least one jurisdiction has issued a final rule uniformly calibrating internal TLAC at the high end of the range—i.e., 90%. This fragmentation can have significant consequences including that a default to the most stringent calibration increases the risk that, in an actual financial distress scenario, there will be insufficient resources left to the parent to allocate where needed. Excessive pre-positioning requirements also mean that financial institutions lose the ability for capital to flow freely where it can be most productive. Finally, a high and rigid internal TLAC requirement also removes useful incentives for the resolution authority or supervisor take steps to increase resolvability. The diverging directions of travel indicate a need for a new global consensus between the FSB and regulators on internal TLAC and re-emphasize the need for more work around how regulators interact across borders on supervision and resolution.

Action 3. Regulatory and supervisory communication and information sharing

Communication and information sharing are necessary precursors to increased coordination and trust among supervisors. This is a complex area due to the number of competing considerations and legal requirements associated with sensitive data, but it is also an extremely important area because it has a very wide reach. For example, it affects day-to-day cross-border supervision, crisis management, the fight against financial crime and pursuit of cyber resilience.

The FSB and global standard setters should define and implement a more cooperative approach to financial data reporting and sharing. This should include data and information sharing for the purposes of combating financial crime and improving cyber security, where national players are faced with common global challenges and adversaries. The FSB should encourage constant and real-time collaboration, which is more efficient both for authorities and for financial services institutions themselves. Such collaboration is probably more likely to be successful – for example, in tackling cyber risk and in crisis management scenarios – as it gives authorities broader and faster actionable information.

Action 4. Market fragmentation as part of the evaluation of reforms

We agree that an important part of making a systematic effort to avoid and remove market fragmentation is to assess *ex post* whether regulatory or supervisory policies or behaviors are contributing to it. This element of monitoring can be conducted through the FSB’s program to analyze the effects of the post-crisis reforms, including the ongoing Small and Medium-Enterprise financing evaluation and recently launched Too-Big-To-Fail (TBTF) evaluation, as well as through the Basel Committee’s Regulatory Consistency Assessment Programme (RCAP).

We agree with the focus in the FSB report on the TBTF evaluation in 2019/20. Market fragmentation is particularly relevant to the regulation and supervision of globally and regionally systemically-important banks. The policy framework that has been developed to deliver on the TBTF objective was built on fundamentally collaborative principles including harmonized standards across jurisdictions. Coordination, mutual trust and preparedness between regulatory authorities across the globe would seem to be a necessary precondition for successful delivery on the TBTF reform objectives.

Indeed, regulatory authorities could undermine confidence in the newly developed global resolution framework by taking actions such as geographical ring-fencing of capital and liquidity as observed in the U.S. and E.U. It is important to evaluate whether the TBTF reform objectives are being achieved or put at risk given how policies are being implemented and operationalized across jurisdictions. Through the course of its evaluation, we hope that the FSB will identify any market fragmentation issues related to the TBTF reforms and their implementation, as well as how broader fragmentary trends in regulation are likely to impact delivery of the TBTF reform objectives. We encourage the FSB to propose actions to remedy any issues that are identified.